Supreme Court, U.S.
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No. 95-

In The

SUPREME COURT OF THE UNITED STATES

October Term, 1995

PHILIP MORRIS INCORPORATED,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR WRIT OF CERTIORARI

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March 6, 1996

QUESTION PRESENTED

Whether the Second Circuit should have followed the Sixth Circuit in Kentucky & Indiana Terminal R.R. v. United States, 330 F.2d 520 (6th Cir. 1964), and held that income realized by petitioner on the repayment of certain foreign currency borrowings constituted "income by reason of the discharge of indebtedness" which qualified for tax deferral under I.R.C. section 108(a), notwithstanding this Court's intervening decision in United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991), which held that income realized by a bank on its early repayment of domestic certificates of deposit did not so qualify.

RULE 29.6 STATEMENT

The parent company of petitioner is Philip Morris Companies Inc., a publicly-owned corporation. Petitioner does not have any subsidiaries that are not wholly owned.

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PETITION FOR WRIT OF CERTIORARI

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit is reported at 71 F.3d 1040 (1995), and is reproduced in the Appendix at pages 3a-14a. The opinion of the United States Tax Court is reported at 104 T.C. 61 (1995), and is reproduced in the Appendix at pages 18a-38a.

JURISDICTION

The judgment of the United States Court of Appeals for the Second Circuit was entered on December 8, 1995. This Court has jurisdiction under 28 U.S.C. section 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 61(a)(12), 108(a) and 1017(a) of the Internal Revenue Code applicable to the years at issue are set forth in the Appendix at pages 40a-41a.[1/] Section 22(b)(9) of the Internal Revenue Code of 1939 is set forth in the Appendix at pages 39a-40a.

STATEMENT OF THE CASE

A. Background

Since this Court's landmark decision in United States v. Kirby Lumber Co., 284 U.S. 1 (1931), it has been clear that the repayment of a debt will give rise to taxable income if the amount repaid is less than the amount borrowed. When the debt involves foreign currency, special rules apply because foreign currency is treated as property, not money, in the hands of a U.S. taxpayer. (A. 8a.)

A borrower of foreign currency is required to account for the transaction as if it were a U.S. dollar loan. The borrowed currency must be translated into dollars at the time of the borrowing in order to determine the U.S. tax consequences that flow from repayment. (Id.) As explained by the Second Circuit below, this means that "a taxpayer may satisfy a foreign currency loan with the exact sum of foreign

---

[1/] Unless otherwise indicated, all section references are to the Internal Revenue Code in effect during the years at issue (the "Code").

currency stipulated and yet realize a gain or loss when the foreign currency is translated into U.S. dollars." (Id.)

As the Second Circuit also noted, prior to the decision of this Court in United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991), the tax treatment of income realized on the repayment of a foreign currency borrowing was well-settled. Such income was characterized as ordinary income under section 61(a)(12) ("income from discharge of indebtedness") rather than as capital gain. (A. 11a, citing Gillin v. United States, 423 F.2d 309, 314 (Ct. Cl. 1970).) As so characterized, the income was eligible for the benefit of tax deferral under section 108(a), as income realized "by reason of the discharge of indebtedness."[2/] (A. 9a, citing Kentucky & Indiana Terminal R.R. v. United States, 330 F.2d 520, 523 (6th Cir. 1964).)

[2/] During the years here at issue, section 108(a)(1) provided in pertinent part:

> "Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if-- * * *
>
> (C) the indebtedness discharged is qualified business indebtedness."

Tax deferral occurs under section 1017(a) through a reduction in the cost basis of the taxpayer's depreciable assets and other property equal to the amount of the "discharge of indebtedness income."

In Centennial, discussed more fully below, this Court denied tax deferral under section 108(a) for income realized by a bank on the early repayment of domestic certificates of deposit because, when the withdrawal occurred, no release was secured from the depositors with respect to any portion of the bank's repayment obligation.

B. Petitioner's Foreign Currency Borrowings

During the early 1980s, petitioner entered into six foreign currency borrowings -- three in Swiss francs, one in Deutsche marks and two in British pounds sterling. In the case of the Swiss franc and Deutsche mark borrowings, petitioner immediately converted the foreign currency received into U.S. dollars for various business uses, including the repayment of short-term dollar debt. (A.19a-23a.) The major advantage of acquiring U.S. dollars in this manner was the substantial interest cost savings available at the time because of lower foreign interest rates. Petitioner used the pound sterling borrowings to pay for certain machinery acquired abroad. (A. 21a-22a.)

Due to favorable market conditions, petitioner chose to prepay each of the Swiss franc borrowings in 1983 (A. 19a-21a), and to prepay a portion of the Deutsche mark borrowing in 1984. (A. 22a-23a.) Petitioner paid regular semi-annual installments on each of its pound sterling borrowings in 1983 and 1984.

With respect to each of petitioner's six borrowings, the U.S. dollar value of the foreign currency involved had declined between the time of the borrowing and the time of repayment. Petitioner therefore realized income on each of its repayments, notwithstanding that the same number of

foreign currency units originally borrowed were repaid. For example, on November 24, 1980, petitioner borrowed 100 million Swiss francs ("SF") from Union Bank of Switzerland, repayable with interest on December 1, 1987. The proceeds of the borrowing were converted into U.S.$58,126,693 on the day they were borrowed. (A. 19a-20a.) On September 1, 1983, petitioner prepaid the SF100 million principal plus accrued interest, when the value of SF100 million had declined to U.S.$45,714,286. (Id.)

In its federal income tax returns for 1983 and 1984, petitioner elected under section 108(a) to defer reporting the income it had realized on the repayment of its borrowings and, as required under section 1017(a), to reduce the cost basis of its depreciable assets by the amount of the income so deferred. (A. 23a.)

Respondent rejected petitioner's elections under sections 108(a) and 1017(a), restored the deferred amounts to current gross income, and determined deficiencies in petitioner's income tax of more than $7.8 million with respect to such amounts for the taxable years 1983 and 1984. (A. 16a, 23a.)[3/]

[3/] For taxable years beginning after December 31, 1986, the U.S. tax consequences of foreign currency borrowings such as those here involved are governed by section 988. That section generally treats as currently taxable ordinary income any income realized on the repayment of a foreign currency borrowing entered into in connection with a trade or business.

C. Proceedings Below

Petitioner brought an action in the United States Tax Court for a redetermination of the deficiencies. The Tax Court (Tannenwald, J.) held for respondent. The court reasoned that under this Court's decision in Centennial, petitioner's income was not realized "by reason of the discharge of indebtedness" within the meaning of section 108(a) because, when petitioner repaid its borrowings, it did not secure releases from its creditors with respect to any portion of its repayment obligations. The Tax Court concluded that the Sixth Circuit's decision in Kentucky & Indiana Terminal R.R., on which petitioner had relied, had been "sapped of its vitality" by Centennial. (A. 34a.)

Petitioner appealed to the United States Court of Appeals for the Second Circuit. That Court (Winter, J.) agreed with the Tax Court that Centennial controlled the outcome of the instant case, while acknowledging that "[u]nder the only court of appeals decision directly on point [Kentucky & Indiana], the foreign exchange transactions in this case would each have been considered a discharge of indebtedness, and the income produced would have been 'by reason of' that discharge." (A. 9a (citation omitted).)

REASONS FOR GRANTING THE WRIT

A. The Second Circuit's Dilemma

The Second Circuit opinion virtually requests a grant of certiorari because of its conflict with the Sixth Circuit in Kentucky & Indiana Terminal R.R. v. United States, 330 F.2d 520 (6th Cir. 1964). That conflict is due entirely to the uncertainty created by this Court's intervening decision in

United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991).

The Second Circuit read Centennial as holding that there can be no "discharge of indebtedness" within the meaning of section 108(a) where the debtor does not secure from its creditor a forgiveness or release from a pre-existing payment obligation, something petitioner did not secure here. Despite its holding, however, the Second Circuit voiced the following concerns:

1. Centennial did not expressly address foreign currency transactions and may not have intended to overturn existing case law, such as Kentucky & Indiana, involving foreign currency borrowings. (A. 11a-13a.)

2. The instant case is similar to United States v. Kirby Lumber Co., 284 U.S. 1 (1931), the landmark case recognized (and reaffirmed in Centennial) as involving a classic example of "discharge of indebtedness income." (A. 13a.)

3. Petitioner's situation "appears to be just the type of situation that Congress sought to ameliorate" through the tax-deferral mechanism of section 108(a). (Id.)

Notwithstanding these expressed concerns, the Second Circuit nevertheless believed it had no choice but to conclude that --

> we are not at liberty to entertain the taxpayer's position in light of the Supreme Court's clear holding in Centennial Savings Bank that Section 108(a) requires a forgiveness or release of an obligation of the

> underlying debt to constitute the requisite discharge of indebtedness.

(Id.)

B. The Sixth Circuit Conflict

In Kentucky & Indiana, the Sixth Circuit had considered the precise question here presented -- whether income realized on the repayment of a foreign currency borrowing was eligible for tax deferral as "income of the taxpayer attributable to the discharge of any indebtedness" under section 22(b)(9) of the 1939 Internal Revenue Code (the predecessor of section 108(a)). The taxpayer had sold British pound sterling bonds to the public at a time when £1 equalled U.S.$4.86. Forty years later, the taxpayer repurchased a number of its bonds in the open market at a cost of less than $2.80 per £1 of face value (the level to which the pound had been officially devalued). There was no indication that the taxpayer had secured releases from its bondholders.

The IRS conceded that the taxpayer had income from the discharge of indebtedness, but only with respect to the difference between the repurchase price paid for the bonds and $2.80 per £1 of face value. The balance of the taxpayer's income was claimed to be gain from currency speculation.

The Sixth Circuit held that the full amount of income realized by the taxpayer was income attributable to the discharge of indebtedness. The court noted that tax deferral under section 22(b)(9) represented the Congressional response to this Court's decision in Kirby Lumber. It concluded that to deny tax deferral to the full extent of the income realized

on the bond repurchases "would defeat the underlying purpose of Section 22(b)(9)." 330 F.2d at 524.

As the Second Circuit observed below, prior to Centennial, the Sixth Circuit's decision in Kentucky & Indiana was generally accepted as governing law in the area of foreign currency borrowings. (A. 11a.) The Second Circuit reluctantly concluded, however, that this Court's decision in Centennial, "while not expressly addressing foreign exchange transactions or the continued viability of Kentucky & Indiana, effectively undermined the latter decision." (Id.)

C. This Court's Holdings in *Centennial Savings Bank* and *Kirby Lumber*

While the conflict between the Second and Sixth Circuits would be reason enough for a grant of certiorari, there is an additional dimension to the instant case. This Court's intervening decision in Centennial Savings Bank has created the uncertainty that produced the conflict.

In Centennial, a bank that issued certificates of deposit had agreed in advance with its depositors that on any given date before a certificate matured, the amount to be repaid would be the principal amount of the deposit plus accrued interest, less a stipulated penalty imposed on the depositor for early withdrawal. This Court held that section 108(a) did not apply to the bank's penalty income because such income was not realized "by reason of the discharge of indebtedness."

According to this Court, a debt is not "discharged" within the meaning of section 108(a) unless the debtor secures a release or forgiveness from its creditor with respect

to some portion of its repayment obligation. 499 U.S. at 580-81. In Centennial, the amount paid by the bank on early withdrawal represented the predetermined amount owed to the depositor on that day. There was thus no remaining payment obligation to be released or forgiven, and hence no "discharge" of any portion of the bank's indebtedness.

In the course of its opinion in Centennial, this Court reaffirmed its landmark decision in Kirby Lumber. That case had involved an open market purchase of dollar-denominated bonds at a discount from their face value. It was the first decision by this Court to hold that a debtor realized income in such a situation. The rationale of Kirby Lumber was explained in Centennial as follows:

> The tax deferral mechanism in §108 is designed to mitigate the effect of treating the discharge of indebtedness as income. See 26 U.S.C. §61(a)(12) (1982 ed.) ("gross income . . . includ[es] . . . income from discharge of indebtedness"). Borrowed funds are excluded from income in the first instance because the taxpayer's obligation to repay the funds offsets any increase in the taxpayer's assets; if the taxpayer is thereafter released from his obligation to repay, the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt, and the basis for the original exclusion thus evaporates. See United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931); Commissioner v. Jacobson, 336 U.S. 28, 38

(1949); see also Commissioner v. Tufts, 461 U.S. 300, 307, 310-311, n.11 (1983).

499 U.S. at 582 (emphasis in original).

Since Kirby Lumber involved an open market repurchase of bonds, there was no mention of (and there would have been no occasion for) the securing of a release or forgiveness by the debtor from its bondholders at the time of repayment. Public bondholders are not likely to know who the open market purchasers of their bonds might be, let alone that the purchaser might be the debtor itself. Yet, when a debtor acquires its own bonds at a discount, it is clear from the very nature of the transaction that a portion of the underlying debt will never be paid because the debt has been extinguished. It is therefore appropriate to treat the repurchase as giving rise to income.

As noted by the Sixth Circuit in Kentucky & Indiana, the decision in Kirby Lumber led Congress to take remedial action. Section 22(b)(9) (the predecessor of section 108(a)) was first enacted in 1939 for the specific purpose of encouraging corporations in weak financial condition (primarily the railroads) to repurchase previously issued bonds that were then selling below par value in the open market. H.R. Rep. No. 855, 76th Cong., 1st Sess. 4-5 (1939); S. Rep. No. 1631, 77th Cong., 2d Sess. 77 (1942). By granting tax deferral under section 22(b)(9) to "income of the taxpayer attributable to the discharge of any indebtedness," Congress sought to remove Kirby Lumber as an impediment to such transactions.

D. The Impact of *Centennial Savings Bank*

Centennial has introduced enormous confusion into the foreign currency area. Although it did not in any way consider the unique tax treatment accorded foreign currency borrowings, both the Tax Court and the Second Circuit considered Centennial to be controlling authority on the issue here presented. Yet, as the Second Circuit acknowledged, given the narrow question presented in Centennial, there is serious doubt whether this Court's holding was intended to apply to foreign currency borrowings.

That doubt is strongly reinforced by the Second Circuit's determination that petitioner's repayments were within the intended scope of section 108(a) during the years at issue. As the court observed, petitioner "has taken advantage of favorable market conditions to eliminate preexisting debt by a payment that fulfills the terms of the original debt but is functionally less than that debt." (A. 13a.) According to Judge Winter:

> It therefore appears to be just the type of situation that Congress sought to ameliorate by "establish[ing] the tax-deferral mechanism in § 108 so that the prospect of immediate tax liability would not discourage businesses from taking advantage of opportunities to repurchase or liquidate their debts at less than face value." Centennial Savings Bank, 499 U.S. at 582-83 (citations omitted).

(Id.)

In Centennial, this Court speculated that "Congress could easily have concluded that only debtors seeking a release from a pre-existing repayment obligation need or deserve the tax break conferred by § 108." 499 U.S. at 583. As the Second Circuit's analysis suggests, however, the legislative history of section 22(b)(9) actually points in a totally different direction.

As noted, the tax-deferral provision was originally enacted to provide the railroads and other companies in financial distress with an incentive to repurchase their bonds at a discount on the open market without incurring immediate tax liability. H.R. Rep. No. 855, 76th Cong., 1st Sess. 4-5 (1939); S. Rep. No. 1631, 77th Cong., 2d Sess. 77 (1942). It is extremely unlikely that a debtor in distress would seek to negotiate releases from its bondholders when it entered the public market to repurchase its bonds at the lowest prices obtainable. That almost certainly explains the complete absence of any indication in the legislative history of section 22(b)(9) that "only debtors seeking a release" were viewed by Congress as needing or deserving the benefit of tax deferral.

In fact, the pertinent legislative history strongly suggests that Congress intended that the requisite "discharge of indebtedness" would occur whenever there was payment by the debtor of an amount less than the face value of the debt, coupled with a resulting extinguishment of the debt.[4/]

[4/] In explaining how section 22(b)(9) was intended to operate, the 1939 House Ways and Means Committee Report provides an example of a taxpayer with two bond issues outstanding. The Report states: "Both issues are discharged by payment less than the face value of the (continued...)

Nothing in the subsequent history of section 108(a), as it was expanded and amended over the years, suggests that Congress ever intended to adopt a narrower meaning of the term for purposes of allowing tax deferral on the repayment of a debt. See, e.g., S. Rep. No. 1631, 77th Cong., 2d Sess. 77-78 (1942); H.R. Rep. No. 1337, 83d Cong., 2d Sess. A28 (1954); S. Rep. No. 1035, 96th Cong., 2d Sess. 20 (1980).

In light of the origin and history of section 108(a), it is wholly illogical and inappropriate to deny petitioner the benefit of that provision. Petitioner was required to account for its borrowings as if they were U.S. dollar borrowings. As the Second Circuit explained, a debtor's repayment of borrowed foreign currency at a time when it has declined in dollar value "fulfills the terms of the original debt but is

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[4/] (...continued)
obligations." H.R. Rep. No. 855, 76th Cong., 1st Sess. 24 (1939) (emphasis added).

The House Report also describes the consequences of repurchasing debt obligations for property rather than cash. "Whenever a discharge of indebtedness is accomplished by the transfer by the debtor of property in kind...." Id. at 25 (emphasis added).

The foregoing statements clearly indicate that Congress did not contemplate that a debtor must invariably secure a release or forgiveness from its creditor in order to achieve a "discharge" of its indebtedness. Bonds could be "discharged by payment" at less than face value. A "discharge" could be "accomplished" by the transfer of property in kind. See also H.R. Rep. No. 1337, 83d Cong., 2d Sess. A28 (1954) ("[T]he general rule to be followed [is] that all discharges of indebtedness should be included in gross income with certain listed exceptions. The general rule pertains to factual situations such as those involved in United States v. Kirby Lumber Company . . .").

functionally less than that debt." (A. 13a.) Because the amount of the repayment is functionally less than the original debt in dollar terms, the debtor is deemed to realize income. But because the repayment literally fulfills the terms of the original debt when expressed in foreign currency, there is no occasion for the debtor to secure a release from its creditor. Yet, the elements of a "discharge of indebtedness" are all in place because it is clear from the very nature of the transaction, just as it was in Kirby Lumber, that the debtor will have no further payment obligation with respect to the unpaid dollar balance of the loan.

This Court's reaffirmance of Kirby Lumber in Centennial would appear to reflect an awareness of the need for some flexibility in applying the "discharge" rules, i.e., by inferring a release or forgiveness, if one is necessary, in appropriate situations. Otherwise, Kirby Lumber itself -- the very case that led to the enactment of what is now section 108(a) -- would fail to satisfy the "discharge" requirements of that section.[5/]

[5/] The Tax Court below reached the rather unusual conclusion that under Centennial, income realized on the repayment of a foreign currency borrowing could not constitute "income by reason of the discharge of indebtedness" within the meaning of section 108(a), but such income might nevertheless constitute "income from discharge of indebtedness" within the meaning of section 61(a)(12). (A. 35a; emphasis added.)

That cannot be the law. Sections 61(a)(12) and 108(a) are in pari materia. See Centennial, 499 U.S. at 582. Also, compare Centennial, 499 U.S. at 579 with 499 U.S. at 580.

The conclusion reached by the Tax Court undoubtedly reflects the confusion introduced into this area by Centennial's holding and its reaffirmation of Kirby Lumber.

A similar flexibility in applying section 108(a) is required when foreign currency borrowings are at issue. Otherwise, Centennial produces an anomalous result -- using dollars to determine whether income is realized on repayment, but using foreign currency to determine whether the income so realized is eligible for tax deferral under section 108(a). Such a result cannot be justified on the basis of the relevant statutory language or its legislative history.

* * *

This Court in Centennial almost certainly did not consider the implications of its holding on foreign currency borrowings. That decision has caused significant confusion and a square conflict between the Second and Sixth Circuits on the question here presented.

Three times in the past eight years, this Court has rendered opinions in the Federal income tax area for the purpose of clarifying its own prior pronouncements in order to provide proper guidance to the lower courts. Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988) (clarifying the scope of Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955)); INDOPCO, Inc. v. Commissioner, 503 U.S. 79, (1992) (clarifying the scope of Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971)); and Commissioner v. Schleier, 115 S. Ct. 2159 (1995) (clarifying the scope of United States v. Burke, 504 U.S. 229 (1992)).

The instant case presents another such situation. While the new rules adopted by Congress in 1986 will preclude the result reached in Kentucky & Indiana in many

cases,[6/] the issue here involved remains an important one. Multinational corporations such as petitioner must have the question resolved for all taxable years still under audit in which income was realized on the repayment of their foreign currency borrowings. In addition, any individual who engages in such a borrowing for nonbusiness reasons (e.g., a corporate employee assigned to an overseas post who acquires a residence and finances the acquisition with a local mortgage) remains eligible for the tax deferral benefits of section 108(a) in the event of insolvency. Cf. Quijano v. United States, 76 AFTR2d (P-H) 7739 (D. Me. 1995).

Given the conflict between the Circuits, as well as the confusion caused by Centennial and the continuing significance of the issue, review of the instant case by this Court is both necessary and appropriate.

[6/] See supra note 3; Staff of the Jt. Comm. on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, 1098 (Comm. Print 1987) ("The [new Section 988] reverses the result in the Kentucky & Indiana Terminal Railroad case.").

* * * * *

CONCLUSION

For all of the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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March 6, 1996

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 8th day of December, one thousand nine hundred and ninety-five.

PRESENT: HON. AMALYA L. KEARSE
HON. RALPH K. WINTER
HON. JOSÉ A. CABRANES,
Circuit Judges.

Docket no.(s): 95-4084

PHILIP MORRIS INCORPORATED,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent - Appelle.

Filed December 8, 1995
George Lange III, Clerk

Appeal from the United States Tax Court.

This cause came on to be heard on the transcript of record from the United States Tax Court and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ORDERED, ADJUDGED and DECREED that the judgment

of said Tax Court be and it hereby is affirmed in accordance with the opinion of this Court, with costs to be taxed against the appellant.

For the Court
GEORGE LANGE III, Clerk

By:

Arthur M. Heller
Administrative Attorney

judmnt_frm

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 508—August Term, 1995

(Argued: November 7, 1995
Decided: December 8, 1995)

Docket No. 95-4084

PHILIP MORRIS INC.,

Petitioner-Appellant,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Before:

KEARSE, WINTER, and CABRANES,
Circuit Judges.

Appeal from a judgment of the United States Tax Court determining deficiencies in appellant's income tax. Appellant argues that it should be permitted to consider the repayment of certain foreign loan obligations in depreciated currency as a "discharge of indebtedness," rendering the net gain from the transactions eligible for tax deferral. We disagree and affirm.

JEROME B. LIBIN, Sutherland, Asbill & Brennan, Washington, D.C. (William S. Corey, David A. Golden, of counsel), *for Petitioner-Appellant.*

CHARLES BRICKEN, United States Department of Justice, Washington, D.C. (Assistant Attorney General Loretta C. Argrett, Gary R. Allen, Richard Farber, of counsel), *for Respondent-Appellee.*

WINTER, *Circuit Judge*:

Philip Morris Inc. appeals from a Tax Court decision (Theodore Tannenwald, Jr., *Judge*) rejecting its claim that income realized from the repayment of a foreign currency loan after the currency has depreciated qualifies as "income by reason of the discharge of indebtedness." Under earlier caselaw, the income in question would have been considered as resulting from such a discharge within the meaning of Section 108 of the Internal Revenue Code in effect for the relevant tax years. We agree with the Tax Court that the Supreme Court's decision in *United States v. Centennial Savings Bank FSB*, 499 U.S. 573 (1991), undermined that caselaw. We therefore affirm.

BACKGROUND

The facts are essentially undisputed. During the period 1980 through 1984, Philip Morris (taxpayer) borrowed and repaid foreign currency in six separate transactions. In four of these transactions, the taxpayer immediately converted the borrowed funds into U.S. dollars. The proceeds from the

remaining two loans were used to purchase certain machinery abroad. In all of the transactions the foreign currency had declined in value against the U.S. dollar by the time of repayment. The taxpayer thus repaid all of the loans in foreign currency with a lower U.S. dollar value than the U.S. dollar value of the currency when borrowed.

The specific transactions were as follows. On November 24, 1980, the taxpayer borrowed 100 million Swiss francs (SF) from Union Bank of Switzerland (UBS), repayable with interest on December 1, 1987. The funds were converted into U.S. dollars on the date they were borrowed at a rate of US $1 per SF 1.72038, for a total of $58,126,693. On September 1, 1983, the taxpayer prepaid the loan principal plus accrued interest, taking advantage of an exchange rate of US $1 per SF 2.1875.[1/] The dollar value of the principal payment was thus $45,714,286.[2/]

On December 22, 1980, the taxpayer borrowed an additional SF 125 million from UBS, repayable with interest on December 31, 1985. The proceeds of this loan were also converted to U.S. dollars on the date of borrowing, at the rate of US $1 per SF 1.81308, for a total of $68,943,455. The taxpayer prepaid the principal and accrued interest and paid a prepayment penalty on May 31, 1983. On that date the

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[1/] The taxpayer conceded in the Tax Court that the repayments of its Swiss franc borrowings had been calculated erroneously using the dollar cost of the Swiss francs used for repayment instead of their dollar value on the date of repayment. This error was reflected in its tax returns.

[2/] On this appeal, we consider the facts as stipulated by the parties and reflected in the Tax Court's decision. We have not independently verified the stipulated figures.

exchange rate was US $1 per SF 2.1005.[3] The U.S. dollar value of the principal payment was therefore $59,509,641.

The final Swiss franc borrowing occurred on December 23, 1980. On that date, the taxpayer borrowed SF 75 million from Swiss Bank Corporation (SBC), to be repaid on December 23, 1985. The proceeds were converted on the same day to U.S. dollars at a rate of US $1 per SF 1.81310, for a total of $41,365,587. On January 7, 1983, the taxpayer prepaid the SF 75 million principal. The exchange rate on the date of repayment was US $1 per SF 1.9340,[4] giving the repayment a U.S. dollar value of approximately $38,799,731.[5]

On December 1, 1981, the taxpayer financed, in pounds sterling, 80 percent of the contract value of certain manufacturing equipment to be purchased by the taxpayer, with the financed amount to be repaid in 10 equal semi-annual installments with interest. The exchange rate between the pound sterling and the U.S. dollar on the dates the machinery was shipped generated a dollar value for 20 percent of the financed amount (representing two semi-annual installments) of $256,592. The taxpayer made two semi-annual installment payments in 1983 and two in 1984, with

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[3] *See supra* note 1.

[4] *See supra* note 1.

[5] The Tax Court appears to have figured the repayment value using an exchange rate of U.S. $1 per SF 2.0150. That was the governing rate on December 22, 1982, when the taxpayer acquired the Swiss francs used for repayment. The taxpayer concedes that the dollar value at repayment is the appropriate measure. *See supra* note 1.

total U.S. dollar values of $215,633 and $188,410, respectively.

On September 2, 1982, the taxpayer entered into a similar transaction, again financing, in pounds sterling, 80 percent of the contract value of manufacturing equipment to be purchased by taxpayer, with the financed amount to be repaid in 10 equal semi-annual installments plus interest. On the date of shipment, 10 percent of the financed amount was equivalent to US $1,063,367. In 1983, the taxpayer made one semi-annual installment payment in pounds sterling having a U.S. dollar value of $981,144, based on the exchange rate on the date of payment. In 1984, the taxpayer made two semi-annual installment payments in pounds sterling having a total U.S. dollar value of $1,759,735, also based on the exchange rate on the dates of payment.

Finally, on February 10, 1982, a wholly owned subsidiary of the taxpayer sold to a German bank, for ultimate sale to the public, 150 million German deutsche marks (DM) of 9 1/2 percent seven-year bearer bonds, which were guaranteed by the taxpayer. The net proceeds of the bearer bond issue amounted to DM 147,888,333 after underwriting fees and other expenses. Those funds were transferred from the subsidiary to the taxpayer on a discount basis on February 16, 1982, and the taxpayer converted the marks into $62,581,611 on the same day at an exchange rate of US $1 per DM 2.36313. From March 12, 1984 through May 3, 1984, the subsidiary repurchased in the market bearer bonds with a total par value of DM 10 million, for a purchase price of DM 10,924,825 plus accrued interest. At the exchange rates prevailing on the dates of prepayments, the value of DM 10 million was $3,769,505.

The taxpayer treated the foreign exchange gain from each of these six transactions as income from "the discharge . . . of indebtedness" on its federal income tax returns. It elected to exclude those amounts from its gross income under I.R.C. § 108 and to reduce the basis of its depreciable assets under I.R.C. § 1017. The Commissioner disallowed the elections and determined deficiencies in taxpayer's income tax for both years. After an unsuccessful petition in the Tax Court for a redetermination of the deficiencies, the taxpayer took the instant appeal.

DISCUSSION

In the hands of a U.S. taxpayer, foreign currency is considered property. *See Federal Nat'l Mortgage Ass'n v. Commissioner*, 100 T.C. 541, 582 (1993). When engaging in a transaction in a foreign currency, therefore, a taxpayer ordinarily must translate the foreign currency into U.S. dollars for the purposes of calculating the U.S. tax consequences of the transaction. *See, e.g., Bernuth Lembcke Co. v. Commissioner,* 1 B.T.A. 1051, 1054 (1925); Rev. Rul. 78-281, 1978-2 C.B. 204. One consequence of this rule is that a taxpayer may satisfy a foreign currency loan with the exact sum of foreign currency stipulated and yet realize a gain or loss when the foreign currency is translated into U.S. dollars. The question presented on this appeal is whether a gain from such borrowing and repayment in depreciated foreign currency is entitled to deferral under the pre-1986 Internal Revenue Code.[6/]

[6/] The Tax Reform Act of 1986 provides that, for tax years beginning after December 31, 1986, foreign currency borrowings such as those involved in this case are governed by I.R.C. § 988, which treats foreign

(continued...)

During the tax years at issue, I.R.C. § 108 provided in pertinent part that

> [g]ross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if . . .
>
> (C) the indebtedness discharged is qualified business indebtedness.

The statutory definition of "qualified business indebtedness" includes "indebtedness . . . incurred or assumed . . . by a corporation," I.R.C. § 108(d)(4)(A), and we assume for the purposes of this appeal that the six loans at issue would so qualify. The core of this dispute is whether the taxpayer's repayments of foreign currency loans are "discharges" within the meaning of the statute, and, if they are, whether the foreign exchange gain produced is by reason of "the discharge of indebtedness."

Under the only court of appeals decision directly on point, the foreign exchange transactions in this case would each have been considered a discharge of indebtedness, and the income produced would have been "by reason of" that discharge. *See Kentucky & Indiana Terminal R.R. v. United States,* 330 F.2d 520, 523 (6th Cir. 1964). In that case, the taxpayer sold bonds denominated in pounds sterling and, after

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[9] (...continued)
currency gain as ordinary income, I.R.C. § 988(a). *See also* Pub. L. No. 99-514, § 822(a), 100 Stat. 2373 (1986 amendment limiting Section 108 to situations in which the taxpayer is insolvent or in bankruptcy at the time of the discharge of indebtedness).

the pound had been devalued, repurchased those bonds in a combination of dollars and pounds for less than face value. The differential between the face value of the bonds and the purchase price thus consisted of two elements: first, the portion attributable to the repurchase of bonds at less than face value and, second, the portion attributable to the decline in the value of the pound sterling. The government urged the Sixth Circuit to construe only the first of these elements as income from the discharge of indebtedness under I.R.C. § 22(b)(9), Section 108's predecessor. The court refused, holding that the taxpayer would not have realized any of the second type of gain "except for the discharge of the indebtedness incurred." 330 F.2d at 523.

The Sixth Circuit noted that Section 22(b)(9) was a congressional reaction to the Supreme Court's decision in *United States v. Kirby Lumber Co.,* 284 U.S. 1 (1931), which held that a taxpayer realized taxable income when it purchased some of its outstanding bonds at a discount from the issuing price. The court pointed out that Section 22(b)(9) responded to the possibility that, under *Kirby Lumber,* a corporation might realize a taxable gain without receiving cash in hand to pay the resultant tax. *Kentucky & Indiana,* 330 F.2d at 524. The court thus held that

> [t]o require the taxpayer in the instant case to include any part of the gain realized from the purchase of its outstanding bonds here involved as taxable income for the year when such bonds were acquired, would defeat the underlying purpose of Section 22(b)(9). Neither the language of this statute nor its legislative history indicate a Congressional

> intent to exclude from the benefits of the statute any of the income attributable to the discharge of taxpayer's indebtedness, for any reason whatsoever.

Id. The Commissioner does not dispute the taxpayer's assertion that, until *Centennial Savings Bank, Kentucky & Indiana* was generally accepted as governing law.[7/]

However, we agree with the Commissioner and the Tax Court that the Supreme Court's decision in *Centennial Savings Bank,* while not expressly addressing foreign exchange transactions or the continued viability of *Kentucky & Indiana,* effectively undermined the latter decision. The issue in *Centennial Savings Bank* was whether a bank could treat funds received as penalties for customers' early withdrawal of certificates of deposit as "income by reason of the discharge . . . of indebtedness" eligible for exclusion from gross income and reduction in basis. 499 U.S. at 575. The Supreme Court responded in the negative on the ground that the depositors who withdrew their deposits and paid the penalties did not discharge Centennial from any obligation of

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[7/] Other decisions have relied upon *Kentucky & Indiana* in holding that foreign exchange gains or losses associated with repaying an obligation in foreign currency are not long-term capital gains or losses, but rather are ordinary income or losses. *See National-Standard Co. v. Commissioner,* 749 F.2d 369, 372 (6th Cir. 1984) (loss realized in paying an obligation in foreign currency as a result of a change in exchange rates is attributable to paying the debt); *Gillin v. United States,* 423 F.2d 309, 314 (Ct. Cl. 1970) ("The [currency] conversions were not independent of, or separate from, the debt but were integral to the arrangement and formed a necessary part of it . . . . [T]here was an assumption and repayment of a debt for less than face value, resulting in ordinary gain . . . .").

the debt. *Id.* at 579. The Court explained that "[a]s used in § 108, the term 'discharge . . . of indebtedness' conveys *forgiveness of,* or *release from,* an obligation to repay." *Id.* at 580 (footnote omitted) (emphasis in original). To determine whether a release of an obligation has occurred, *Centennial Savings Bank* suggested scrutiny of both the end result of the transaction and the repayment terms agreed to at the outset of the lender-borrower relationship. *Id.* at 581. Because, in Centennial's case, the prepayment penalty income was an original term of the certificate of deposit and not the result of the release of any legal obligation, the Supreme Court held that the prepayment penalty did not constitute income by reason of a discharge. *Id.*

In the instant case, the Tax Court held that the rationale of *Centennial Savings Bank* applied and that the taxpayer's gains from the foreign currency transactions were not the result of a discharge of indebtedness within the meaning of Section 108. *Philip Morris Inc. v. Commissioner,* 104 T.C. 61, 73 (1995). In the Tax Court's view, although a satisfaction of indebtedness in depreciated currency may be the occasion for the realization of income, the income is not realized "by reason of the discharge . . . of indebtedness" under Section 108 unless there is a forgiveness or release of an obligation imposed in connection with the underlying debt. *Id.*

The taxpayer argues that the Supreme Court did not have foreign exchange transactions in mind when it decided *Centennial Savings Bank.* This may be true. Indeed, the Court's opinion appears predicated, in part, on a desire to avoid a tax windfall to those who are relieved of a debt in circumstances that generate current income. Here, in

contrast, the taxpayer has taken advantage of favorable market conditions to eliminate preexisting debt by a payment that fulfills the terms of the original debt but is functionally less than that debt. Unlike *Centennial Savings Bank*, the facts of this case are similar to those presented in *Kirby Lumber*. It therefore appears to be just the type of situation that Congress sought to ameliorate by "establish[ing] the tax-deferral mechanism in § 108 so that the prospect of immediate tax liability would not discourage businesses from taking advantage of opportunities to repurchase or liquidate their debts at less than face value." *Centennial Savings Bank*, 499 U.S. at 582-83 (citations omitted). The legislative history of Sections 22(b)(9) and 113(b)(3), the progenitors of Sections 108 and 1017, provides some support for this argument. *See* S. Rep. No. 1631, 77th Cong., 2d Sess. 77 (1942). Nevertheless, we are not at liberty to entertain the taxpayer's position in light of the Supreme Court's clear holding in *Centennial Savings Bank* that Section 108(a) requires a forgiveness or release of an obligation of the underlying debt to constitute the requisite discharge of indebtedness. 499 U.S. at 583.

One final matter remains. The taxpayer argues that if, as we have determined, the rationale of *Centennial Savings Bank* governs the disposition of this case, four of the transactions—the three Swiss franc loans and the German mark loan—fall within the requirements of *Centennial Savings Bank* because the taxpayer took affirmative action to prepay those borrowings. We disagree. In each case, the prepayment represented the fulfillment of the original obligation to repay the amount borrowed. While the repayment may have been accelerated and may have entailed negotiation over the prepayment fee and other ancillary

matters, the foreign exchange gains here resulted not from the forgiveness of an obligation to pay but from the performance of that obligation. They thus fall outside the scope of Section 108 as interpreted by *Centennial Savings Bank*.

We therefore affirm.

UNITED STATES TAX COURT

Received May 22, 1995

PHILIP MORRIS INCORPORATED, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 28279-92

NOTICE OF APPEAL

Notice is hereby given that petitioner, Philip Morris Incorporated, hereby appeals to the United States Court of Appeals for the Second Circuit from that part of the decision of this Court entered in the above-captioned proceeding on April 7, 1995, relating to the proper treatment of certain gains resulting from foreign currency borrowings.

May 22, 1995

Jerome B. Libin
Tax Court No. LJ0518

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UNITED STATES TAX COURT

PHILIP MORRIS INCORPORATED,	)	
	)	
Petitioner,	)	
	)	
v.	)	Docket No. 28279-92
	)	
COMMISSIONER OF INTERNAL REVENUE	)	
	)	
	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed January 23, 1995, and incorporating herein the facts recited in respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there are deficiencies in income tax due from the petitioner for the taxable years 1982, 1983 and 1984 in the amounts of $365,554, $8,445,426 and $1,900,758 respectively.

(Signed) THEODORE TANNENWALD JR.

Judge.

Entered: April 7, 1995

Docket No. 28279-92

The parties stipulate that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision without prejudice to the right of either party to contest the correctness of the decision entered herein.

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Date: April 5, 1995

PHILIP MORRIS INCORPORATED, PETITIONER
v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 28279-92. Filed January 23, 1995.

P borrowed in foreign currencies which it converted into U.S. dollars and later repaid the borrowings in the same foreign currency which it had purchased with U.S. dollars. P reported its gain, represented by the difference in U.S. dollars between the value of the foreign currencies at the time of the borrowings and the U.S. dollar cost of the currencies used for repayment, as income from the discharge of indebtedness and elected to exclude such income from gross income under sec. 108, I.R.C., and reduce the basis in its assets under sec. 1017, I.R.C. *Held*: P's gain does not constitute income by reason of the discharge of indebtedness eligible for exclusion from gross income under sec. 108, I.R.C. *Kentucky & Ind. Terminal R.R. v. United States*, 330 F.2d 520 (6th Cir. 1964), has been sapped of its vitality by *United States v. Centennial Sav. Bank FSB*, 499 U.S. 573 (1991).

Jerome B. Libin, William S. Corey, and *David A. Golden,* for petitioner.

Lewis R. Mandel, for respondent.

OPINION

TANNENWALD, *Judge*: Respondent determined deficiencies in petitioner's Federal income taxes for the 1982, 1983, and 1984 taxable years in the amounts of $4,594,256, $11,217,945, and $6,111,795, respectively. The parties have settled all but one issue involving the proper treatment of gains resulting from the use of foreign currency, the value of which changed in relation to the U.S. dollar between the dates of borrowings and repayments in the same currency.

All the facts have been stipulated and are so found. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference.

Petitioner is a corporation organized and existing under the laws of the Commonwealth of Virginia with its principal office in New York, New York. During the taxable years in issue, petitioner was the common parent of a group of affiliated corporations. At all relevant times, petitioner used the accrual method of accounting and filed consolidated Federal income tax returns for the taxable years before us with the Internal Revenue Service, Holtsville, New York.

Petitioner engaged in the following six transactions:

(1) On November 24, 1980, petitioner borrowed 100 million Swiss francs (SF) from Union Bank of Switzerland (UBS). The loan bore interest at 6½ percent per annum and was repayable on December 1, 1987. The proceeds were converted into U.S. dollars on the date of borrowing, at the rate of US$1 equals SF1.72038, for a total of

$58,126,692.94. On September 1, 1983, petitioner prepaid the principal plus accrued interest, without incurring a prepayment penalty. On that date, the spot rate was US$1 equals SF2.1875 so that the U.S. dollar value of the principal payment was $45,714,286. The source of the SF100 million prepayment was: (a) SF85,229,861 acquired by petitioner on May 31, 1983, and placed on deposit with UBS until the date of prepayment, which amount was part of the proceeds of six forward contracts purchased by petitioner on May 10, 1983, at a weighted average rate of exchange of US$1 equals SF2.03045218; (b) accrued interest income of SF981,250 on said deposit, converted at an exchange rate of US$1 equals SF2.1433; and (c) SF13,788,889 acquired by petitioner on September 1, 1983, which amount was part of the proceeds of a forward contract purchased by petitioner on August 18, 1983, at an exchange rate of US$1 equals SF2.1433.

(2) On December 22, 1980, petitioner borrowed SF125 million from UBS. The loan bore interest at 7 percent per annum and was repayable on December 31, 1985. The proceeds were converted on the date of borrowing at the rate of US$1 equals SF1.81308, for a total of $68,943,455.34. On May 31, 1983, petitioner prepaid to UBS the principal and accrued interest plus a prepayment penalty. On that date the spot rate was US$1 equals SF2.1005, so that the U.S. dollar value of the principal payment was $59,509,641. The SF125 million was acquired on May 31, 1983, as part of the proceeds of the SF280.6 million in aggregate forward contracts purchased by petitioner on May 10, 1983, at a weighted average exchange rate of US$1 equals SF2.03045218.

(3) On December 23, 1980, petitioner borrowed SF75 million from Swiss Bank Corp. (SBC). The loan bore interest at 7 percent per annum and was repayable on December 23, 1985. The proceeds were converted on the date of borrowing at the rate of US$1 equals SF1.81310, for a total of $41,365,586.86. On January 7, 1983, petitioner prepaid the SF75 million principal. On that date, the spot rate was US$1 equals SF1.9340. The source of the SF75 million was a SF100 million private placement issue by petitioner on December 22, 1982, when the spot rate was US$1 equals SF2.0150, so that the U.S. dollar value of the repayment was $37,220,844.

(4) On January 13, 1982, petitioner financed, in pounds sterling, 80 percent of the contract value of certain rotary tobacco-cutting machines purchased by petitioner, with the financed amount (including a 2.6-percent finance charge equivalent) to be repaid in 10 equal semiannual installments with interest at 8.5 percent per annum on the unpaid balance. The pound sterling/dollar exchange rate of the 80 percent of the contract value plus the finance charge equivalent was US$1,282,959 and of two semiannual installments was US$256,592. In 1983, two semiannual installments were paid in pounds sterling having U.S. dollar value of $215,633 based on the exchange rate on the dates of payment. In 1984, two semiannual installments were paid in pounds sterling, the U.S. dollar value of such repayment being US$188,410.

(5) On September 28, 1982, petitioner financed, in pounds sterling, 80 percent of the contract value of certain cigarette manufacturing machinery to be purchased by petitioner, with the financed amount (including a 2.6-percent

finance charge equivalent) to be repaid in 10 equal semiannual installments and interest at 11 percent per annum on the unpaid balance. The contemporaneous pound sterling/dollar exchange rate of the 80 percent of the contract value plus the finance charge equivalent was US$10,633,669, and one semiannual installment was equivalent to US1,063,367, and of two semiannual installments was equivalent to US$2,126,734. In 1983, petitioner made one semiannual installment payment in pounds sterling having a U.S. dollar value of $981,144, based on the exchange rate on the date of payment. In 1984, petitioner made two semiannual installment payments in pounds sterling having a total U.S. dollar value of $1,759,735 based on the exchange rate on the dates of payment.

(6) On February 10, 1982, a wholly owned subsidiary of petitioner sold to a German bank, for ultimate sale to the public, 150 million German marks (DM) of 9½-percent, 7-year bearer bonds, which were guaranteed by petitioner. The net proceeds of the bearer bond issue amounted to DM147,888,333.33 after underwriting and other expenses. The net proceeds were transferred from the subsidiary to petitioner on a discount basis at a 10½-percent interest rate on February 16, 1982. Petitioner received DM147,888,333.33 and was obligated to repay DM150 million. The net proceeds of DM147,888,333.33 were converted by petitioner into US$62,581,611.08 on February 16, 1982, at an exchange rate of US$1 equals DM2.36313. From March 12 through May 3, 1984, the subsidiary purchased in the market bearer bonds with an aggregate par value of DM10 million, at an aggregate purchase price of DM10,924,824.92 plus accrued interest. A portion of the funds for the repurchase of bonds was supplied

by petitioner through a series of prepayments by it aggregating DM10 million of its intercompany indebtedness to the subsidiary, plus accrued interest. At the exchange rates on the dates of prepayments, the cost of DM10 million was US$3,769,505.

In each transaction, the value of the foreign currency had decreased in value relative to the U.S. dollar between the date the borrowings were incurred and the date of repayment, so that fewer dollars were necessary to acquire the foreign currency for repayment than the U.S. dollar value of the borrowings at the time they were created.

In its consolidated returns for 1983 and 1984, petitioner treated its gain from the aforesaid use of foreign currency (hereinafter referred to as exchange gain), representing the difference between the U.S. dollar value of the foreign currency on the date of borrowing and the dollar cost of the currency used for repayment, as income from the discharge of indebtedness under section 108[1/] and reduced its basis under section 1017 by the same amount.

In the notice of deficiency, respondent disallowed petitioner's elections under section 108 and treated the amounts of gain reported by petitioner as section 61 ordinary income and not income from discharge of indebtedness eligible for such election.

Section 108 provides in pertinent part:

[1/] Unless otherwise indicated, all statutory references are to the Internal Revenue Code in effect for the years at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

SEC. 108(a). EXCLUSION FROM GROSS INCOME.—

(1) IN GENERAL.—Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

* * * * * * *

(C) the indebtedness discharged is qualified business indebtedness.

"[I]ndebtedness of the taxpayer" means any indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property. Sec. 108(d)(1). Indebtedness is treated as "qualified business indebtedness" where it is incurred or assumed by a corporation which elects to treat it as such indebtedness. Sec. 108(d)(4).[2/] The amount excluded as qualified business indebtedness "shall be applied to reduce the basis of the depreciable property of the taxpayer", as provided by section 1017. Sec. 108(c)(1). Thus, section 108 does not exempt income from taxation, but defers the payment of tax.

Petitioner initially argues that: (1) For purposes of determining their U.S. tax consequences, the borrowings must be accounted for as if they were U.S. dollar borrowings; (2) it satisfied its indebtedness for fewer dollars than it originally borrowed; and (3) in this context, the classic test of income from the discharge of indebtedness has been satisfied, and consequently such income is eligible for exclusion from gross

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[2/] Respondent does not dispute that petitioner made a timely and proper form of election.

income under section 108 and reduction of basis under section 1017. Petitioner further asserts that its exchange gain should be recomputed so as to represent the difference between the U.S. dollar value of the foreign currency on the date of the borrowings and the U.S. dollar value of that currency on the date or repayment. Petitioner also suggests, without explanation or argument, that it is entitled to recognize gain or loss on the difference between the U.S. dollar value of the foreign currency used to repay the borrowings at the date that currency was acquired and such value at the time of repayment.

Respondent argues that, because the foreign currency obligations were paid in full in the same currency, there was no "discharge of indebtedness" within the meaning of section 108 and therefore petitioner is not entitled to exclude the exchange gain from income under that section. Respondent further contends that, in any event, the exchange gain was not income from discharge of indebtedness within the meaning of section 61(a)(12), and that we should overrule our decision in *National-Standard Co. v. Commissioner*, 80 T.C. 551 (1983), affd. 749 F.2d 369 (6th Cir. 1984), and hold that the exchange gain constituted short-term capital gain measured by the difference between the U.S. dollar value of the foreign currency on the date the indebtedness was incurred and the U.S. dollar value of the foreign currency used in repayment on the date it was acquired (not the date of repayment) and based upon a holding period measured from the date the foreign currency used for repayment was acquired and the date of repayment. Respondent does not address the question of how we should treat the difference between the U.S. dollar value on the date of acquisition of the foreign currency and such value of the date of repayment.

Initially, we note that neither party disputes the proposition that exchange gain arises as a result of a transaction separate from the underlying transaction in respect of which the foreign currency or its proceeds in U.S. dollars were used, e.g., to acquire property. See, e.g., *Church's English Shoes, Ltd. v. Commissioner*, 229 F.2d 957 (2d Cir. 1956), affg. per curiam 24 T.C. 56 (1955); *FNMA v. Commissioner*, 100 T.C. 541, 583 (1993); *Levin v. Commissioner*, 87 T.C. 698, 729 n.19 (1986), affd. 832 F.2d 403 (7th Cir. 1987); *National Standard Co. v. Commissioner*, 80 T.C. at 555; *Willard Helburn, Inc. v. Commissioner*, 20 T.C. 740 (1953), affd. 214 F.2d 815 (1st Cir. 1954); H. Conf. Rept. 99-841 (Vol. II), 1986-3 C.B. (Vol. 4) 1, 662.[3/] Nor do the parties disagree that foreign currency in the hands of a U.S. taxpayer is considered property. *FNMA v. Commissioner*, 100 T.C. at 582.

We deal first with petitioner's assertion that we should treat the transactions involved herein as borrowings and repayments in U.S. dollars. Admittedly, there is language in the decided cases which lends support to this position. Thus, in *America-Southeast Asia Co. v. Commissioner*, 26 T.C. 198 (1956), the taxpayer borrowed pounds sterling to purchase

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[3/] Under *Bowers v. Kerbaugh Empire Co.*, 271 U.S. 170 (1926), it was once uncertain whether borrowing, such as is involved herein, produced taxable gain, see, e.g., *B.F. Goodrich Co. v. Commissioner*, 1 T.C. 1098 (1943); *Coverdale v. Commissioner*, a Memorandum Opinion of this Court dated June 28, 1945, but that line of cases now holds little validity, *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409 (9th Cir. 1986), affg. in part and revg. in part T.C. Memo. 1984-611; *National-Standard Co. v. Commissioner*, 80 T.C. 551, 568-569 (Tannenwald, J. dissenting) (1983), affd, 749 F.2d 369 (6th Cir. 1984); *Willard Helburn, Inc. v. Commissioner*, 20 T.C. 740 (1963), affd. 214 F.2d 815 (1st Cir. 1954); Ravenscroft, Taxation and Foreign Currency 214 (1973).

burlap, of which it was a dealer, and realized exchange gain on the repayment of its obligation with the same amount of pounds sterling. In the course of deciding that the gain should be treated as ordinary income from the taxpayer's business of dealing in burlap and not as capital gain arising from speculation in foreign exchange separate from that business, we stated at 200:

> The end result of petitioner's purchase of burlap with borrowed pounds sterling was that it was able to purchase burlap worth $96,013.33 and subsequently settle the debt which it owed for $66,603.32. We are satisfied that the resulting gain, while measured by the difference in the value of pounds sterling at the time they were borrowed and the value when they were repaid, is a gain arising directly out of petitioner's trade or business from the settlement of a debt incurred therein *for less than its face amount.* * * * [Emphasis added.]

We think our translation of the transaction into dollars was for the limited purpose of deciding the issue of capital gain versus ordinary income from a trade or business. In this connection, we note that there is no reference in our opinion to the question whether the ordinary income constituted income from the discharge of indebtedness that could be excluded from gross income under the then-applicable sections 22(b)(9) and 113(b)(3) of the Internal Revenue Code of 1939 (the predecessors of sections 108 and 1017, involved herein). Similar reasoning disposes of Rev. Rul. 74-122, 1974-1 C.B. 21, and Rev. Rul. 78-281, 1978-2 C.B. 204,

cited by petitioner, which dealt with the measurement of foreign currency income received for the performance of services and the purchase price of property acquired with foreign currency.

In *Gillin v. United States*, 191 Ct. Cl. 172, 423 F.2d 309 (1970), the taxpayer borrowed Canadian dollars which he immediately converted into U.S. dollars for the payment of personal expenses and investments. He repaid these borrowings in the same amount of Canadian dollars which he had purchased with U.S. dollars at the time or repayment. In the interval between the borrowing and the repayment, the Canadian dollar had depreciated in value vis-a-vis the U.S. dollar. The Court of Claims held that the gain should be treated as income from the discharge of indebtedness under section 61(a)(12) and not as capital gain. In so holding, the Court of Claims stated at 423 F.2d 313: "In effect, the taxpayer borrowed United states funds, and the source of his gain was a decline in the value of the debt in terms of American dollars, enabling him to retire it for less United States currency than he received in incurring it." Here again, the issue involved the characterization of the exchange gain between two types of income for purposes of inclusion in gross income; the issue of excludability under section 108 was not involved, presumably because the borrowings did not meet the requirement of qualified business indebtedness. Moreover, we note that the Court of Claims did not say there *was* borrowing and repayment in U.S. dollars but merely stated that this is *in effect* what happened. Our view that this difference in expression should be accorded significant impact is reinforced by the fact that the court's immediately preceding sentence referred to the proximity of the conversions to the loan and repayment as making "clear that

plaintiff's intent in borrowing the Canadian dollars was to acquire United States money at once and that currency, in turn, was to be used later to buy back Canadian Funds to repay the debt, if possible at an exchange profit." *Id.* Thus, we are satisfied that the language of the Court of Claims does not inhibit our analysis of the issue of the exclusion from gross income under section 108.

Finally, we address *National-Standard Co. v. Commissioner*, 80 T.C. 551 (1983). In that case, the taxpayer borrowed Luxembourg francs to acquire a 50-percent stock interest in a Luxembourg corporation. Later, the taxpayer refinanced the loan with Belgian francs, which had the same dollar value as Luxembourg francs. After selling the stock in the Luxembourg corporation, the taxpayer purchased sufficient Belgian francs, with U.S. dollars, to repay the debt. At each step, the value of the U.S. dollar had decreased compared to both the Luxembourg and Belgian francs. In holding there was no sale or exchange of foreign currency, we stated:

> Likewise, when petitioner purchased francs to repay the Societe Generale loan, the purchased francs were transferred the same day to Societe Generale in satisfaction of the debt. Consequently, under the rationale of *Kenan v. Commissioner* [, 114 F.2d 217 (2d Cir. 1940),] no loss was realized.[12/]
>
> And yet, petitioner certainly realized an economic loss upon the repayment of each of the loans herein as a result of the currency fluctuations, which loss is recognized for tax purposes. This [exchange] loss * * * was due

to the fact that the amount of the debt itself had increased, in terms of U.S. dollars.

In short, the losses incurred herein were the result of the repayment of an indebtedness with more U.S. dollars than were originally borrowed.[13/] * * *

[12/] * * * However, the amount petitioner "realized" was not the U.S. dollar value of francs when borrowed. Rather, it was the extinguishment of a debt at a time that debt had a U.S. dollar value equal to the cost of the francs used to pay off such debt.

[13/] *This is not to say that the amount repaid was in fact more than the face amount of the debt. To the contrary, exactly what was owed, was paid*, to wit, BF250 million. Rather the U.S. dollar cost of repaying that loan had increased.

[*National-Standard Co. v. Commissioner*, 80 T.C. at 563-564; emphasis added.]

We think petitioner's reliance on the first italicized language is misplaced particularly since, although it quotes the second italicized language constituting footnote 13, it fails to discuss the impact of footnote 13. Clearly, we were attempting to reconcile the fact that there was no loss realized upon the actual satisfaction of the debt with the fact that there was an economic loss from the combined transactions. Discussion of paying the debt with more U.S. dollars was used merely to explain there was an economic loss, despite

paying back the face value of the debt. Footnote 13 specifically explains that, despite exchange loss, the face amount of the debt was paid, thus indicating that our discussion of U.S. dollars should not be interpreted as applying in a different context such as is involved herein.

In view of the foregoing, we are not disposed to deem the borrowings and repayments herein as representing only U.S. dollar transactions and ignore the fact that they were undertaken and implemented in accordance with their terms; i.e., in foreign currencies. See Miller, "Foreign Currency Transactions: A Review of Some Recent Developments", 33 Tax Law. 825, 838 (1980). But see Newman, "Tax Consequences of Foreign Currency Transactions: A Look at Current Law and an Analysis of the Treasury Department Discussion Draft", 36 Tax Law. 223, 232 (1983).

In the final analysis, our disposition of the issue before us turns upon whether we should apply *Kentucky & Ind. Terminal R.R. v. United States*, 330 F.2d 520 (6th Cir. 1964) (*Kentucky & Indiana*), as petitioner contends, or *United States v. Centennial Sav. Bank FSB*, 499 U.S. 573 (1991) (*Centennial Savings*), as respondent contends.

In *Kentucky & Indiana*, the taxpayer, in 1911, issued bonds in pounds sterling. In 1951, it purchased 438 of these bonds in the open market, paying for most of them in U.S. dollars and the remainder in pounds sterling. The excess of the face value of the bonds over the purchase price consisted of two elements: (1) The discount between the face value of the bonds in U.S. dollars and the acquisition price, and (2) the difference between the 1911 and 1951 values of the pounds sterling. The taxpayer elected to exclude such excess from gross income and reduce its basis in its assets under

sections 22(b)(9) and 113(b)(3) of the Internal Revenue Code of 1939 (the predecessors of sections 108 and 1017). Respondent allowed the election to the extent of the first element of the excess but disallowed the amount represented by the second element. The Court of Appeals for the Sixth Circuit held for the taxpayer on the ground that the exchange gain represented by the second element would not have been realized "except for the discharge of the indebtedness incurred". 330 F.2d at 523. It reasoned that the taxpayer "would derive no funds with which to pay the tax" on such gain and went on to state:

> To require the taxpayer in the instant case to include any part of the gain realized from the purchase of its outstanding bonds here involved as taxable income for the year when such bonds were acquired, would defeat the underlying purpose of Section 22(b)(9). Neither the language of this statute nor its legislative history indicate a Congressional intent to exclude from the benefits of the statute any of the income attributable to the discharge of taxpayer's indebtedness, for any reason whatsoever. [330 F.2d at 524.]

In *United States v. Centennial Sav. Bank FSB, supra*, the issue was whether a penalty for early withdrawal of time deposits, in accordance with restrictions in the agreements governing the deposits, constituted income from the discharge of indebtedness eligible for exclusion and reduction in basis under sections 108 and 1017. The Supreme Court held that it was not so eligible on the ground that the withdrawal, consisting of the face amount of the deposit less the penalty

for early withdrawal, was in accordance with the terms of the deposit, i.e., at the agreed face value under such circumstances. Petitioner argues that *Centennial Savings* did not involve foreign currency transactions, that the Supreme Court made no reference to *Kentucky & Ind. Terminal R.R. v. United States, supra*, or any other cases involving foreign currency transactions, and that it held only that a payment of a dollar indebtedness at less than its original amount in accordance with terms of repayment (a situation that did not exist in *Kentucky & Indiana*) does not give rise to income from the discharge of indebtedness within the meaning of section 108. Consequently, petitioner asserts that *Kentucky & Indiana* retains its vitality and controls our decision herein.

Petitioner unduly narrows the scope of *Centennial Savings* when it seeks to confine its impact to situations where the amount of the repayment of an indebtedness at less than its face value is "determinable under the express terms of the original borrowing documentation." The Supreme Court's articulation of the scope of section 108 goes beyond the factual context of that case. We think that the articulation rests upon a broad fundamental premise, namely:

> As used in §108, the term "discharge * * * of indebtedness" conveys *forgiveness of*, or *release from* an obligation to repay.[6/]

[6/] "Discharge" can be used to signify various means of extinguishing a legal duty. See generally Black's Law Dictionary 463 (6th ed. 1990). Thus, a debtor might be said to "discharge" his debt by satisfying it. But § 108 uses "income by reason of the discharge

> * * * of indebtedness" to refer to the change in the debtor's financial condition when the debtor is no longer legally required to satisfy his debt either in part or in full. "Discharge" in this sense can occur only if the creditor cancels or forgives a repayment obligation.
>
> [*United States v. Centennial Savings Bank FSB*, 449 U.S. at 580-581.]

In footnote 7, it concludes that "Centennial's reliance on §108 fails for a * * * fundamental reason—the absence of a 'discharge' for purposes of the statute." *Id.* at 582 n.7.

Granted that *Centennial Savings* did not expressly overrule *Kentucky & Indiana*, it cannot be gainsaid that the rationale of the Supreme Court is inconsistent with that of the Court of Appeals for the Sixth Circuit. We are satisfied that, at least as far as this case is concerned, *Kentucky & Indiana* has been sapped of its vitality. See *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409, 1416 (9th Cir. 1986), affg. in part and revg. in part T.C. Memo 1984-611 (where the impact of a Supreme Court opinion is not clearly discernible, it is up to the lower court to decide the case before it according to its reasoned "view of the way the Supreme Court would decide the pending case today"); see also *Hicks v. Commissioner*, 47 T.C. 71, 74 (1966).[4/] In the same vein, we are satisfied that, if our analysis of the language of *America-Southeast Asia Co. v. Commissioner*, 26 T.C. 198

[4/] We note that, in any event, we would not necessarily be bound by *Kentucky & Ind. Terminal R.R. v. United States*, 330 F.2d 520 (6th Cir. 1964), since an appeal in this case would not lie to the Court of Appeals for the Sixth Circuit. *Golsen v. Commissioner*, 54. T.C. 742 (1970), affd., 445 F.2d 985 (10th Cir. 1971).

(1956); *Gillin v. United States*, 191 Ct. Cl. 172, 423 F.2d 309 (1970); and *National-Standard Co. v. Commissioner*, 80 T.C. 551 (1983), is incorrect, *Centennial Savings* deprives petitioner of any support therefrom. Moreover, the Supreme Court concluded "that Congress did not intend to extend the benefits of §108 beyond the setting in which a creditor agrees to release a debtor from an obligation assumed at the outset of the relationship." *United States v. Centennial Sav. Bank FSB*, 499 U.S. at 584. This statement directly conflicts with that of the Court of Appeals for the Sixth Circuit in *Kentucky & Ind. Terminal R.R. v. United States, supra*, as to legislative intention (see *supra* p. 71).

We think the teaching of *Centennial Savings* is clear, namely that the discharge of an indebtedness may be the occasion for the realization of income but, unless there is a cancellation or forgiveness of a portion of the indebtedness not reflected in the terms of the indebtedness, such income is not realized "*by reason of the discharge* * * * of indebtedness of the taxpayer" (emphasis added) as required by section 108(a). See Ravenscroft, Taxation and Foreign Currency 215-216 (1973).

The conclusion that the *occasion* may differ from the *reason* for realization finds support in the fact that petitioner would have had no taxable gain absent its conversion of the proceeds of the borrowings to, and the obtaining of the means of repayment from, U.S. dollars. If the foreign currency had not been exchanged, and instead held in its borrowed form, petitioner would have had a loss (albeit unrealized) on the value of its currency in hand exactly offsetting the economic gain (albeit unrealized) from repayment in a devalued currency, and thus no gain or loss

for tax purposes. *Willard Helburn, Inc. v. Commissioner*, 20 T.C. 740, 743 (1953), affd. 214 F.2d 815 (1st Cir. 1954); see *National-Standard Co. v. Commissioner*, 80 T.C. at 569 n.4 (Tannenwald, J., dissenting) ("the value at the time of borrowing and the cost of acquisition would be the same"). Petitioner has taxable gain on the *occasion* of the discharge of its indebtedness but only because it exchanged the foreign currency for U.S. dollars (the *reason*).

Our interpretation of section 108 finds support in the legislative history of section 22(b)(9) of the Internal Revenue Code of 1939 (the predecessor of section 108). At the time of its initial enactment, in the Revenue Act of 1939, ch. 247, sec. 215, 53 Stat. 862, 875, the report of the House Ways and Means Committee made clear that the purpose of the section was to provide relief to a corporate taxpayer which acquired its evidences of indebtedness "at less than their fact value". H. Rept. 855, 76th Cong., 1st Sess. 7 (1939), 1939-2 C.B. 504, 507; see *Colonial Sav. Association v. Commissioner*, 854 F.2d 1001, 1005 (7th Cir. 1988), affg. 85 T.C. 855 (1985) and 87 T.C. 665 (1986); see also S. Rept. 1631, 77th Cong., 2d Sess. 77 (1942), 1942-2 C.B. 504, 564, referring to the repurchase of a corporation's "own bonds at a discount"; Report of the Staff of the Joint Committee on Internal Revenue Taxation 23 (1951), referring to a corporation which "buys back its own bonds at less than their face value". We are unimpressed with petitioner's effort to find sustenance in the fact that, in enacting section 988,[5/] the legislative history

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[5/] For tax years beginning after Dec. 31, 1986, foreign currency borrowings, such as are involved herein, are subject to sec. 988. The borrowings are considered "section 988 [transactions]", sec.

(continued...)

indicates that section 988 "reverses the result in the *Kentucky & Indiana Terminal Railroad* case" and that business taxpayers "rely on this decision". S. Rept. 99-313 (1986), 1986-3 C.B. (Vol. 3) 1, 435, 461; Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, at 1, 1070, 1098 (J. Comm. Print 1987). Leaving aside the impact of the later opinion of the Supreme Court in *United States v. Centennial Sav. Bank FSB, supra*, on the 1986 legislative history, we think petitioner gives it too broad a reading. There is nothing in that history to indicate that Congress was approving public understanding or the judicial resolution of the issue before us; Congress only said that it was establishing a new set of rules, irrespective of the correctness of preexisting case law.

In sum, we hold that petitioner's exchange gain was not "includible in gross income by reason of the discharge" of its indebtedness within the meaning of section 108, and therefore petitioner is not entitled to elect to exclude such income under section 108 and reduce the basis in its assets under section 1017. Under the circumstances of this case, where, as far as we can determine, the amount to be included does not depend upon its characterization as ordinary income or short-term capital gain, we have no need to address respondent's argument in this respect. Discussion of respondent's argument would require us to revisit *National-Standard Co. v. Commissioner, supra*, a path which we are not inclined to travel under the circumstances herein. In this connection, we note that it does not necessarily follow, as

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[2/] (...continued)
988(c)(1)(A)(i) and (B)(i), and the foreign currency gain is treated as ordinary income, sec. 988(a).

respondent appears to assert, that a holding that income does not arise "*by reason of* the discharge * * * of indebtedness" (emphasis added) requires the conclusion that it is not "income from discharge of indebtedness" under section 61(a)(12). Similarly, we find it unnecessary to consider petitioner's suggestion, see *supra* pp. 65-66, that we break the exchange gain into two parts.[6/]

In order to reflect our holding herein and the disposition of the settled issues,

Decision will be entered under Rule 155.

[6/] If we are in error as to the lack of necessity to deal with these arguments, they can be dealt with under Rule 155.

STATUTORY PROVISIONS

INTERNAL REVENUE CODE OF 1939

Section 22. * * * (b) EXCLUSIONS FROM GROSS INCOME — The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * *

(9) INCOME FROM DISCHARGE OF INDEBTEDNESS — In the case of a corporation, the amount of any income of the taxpayer attributable to the discharge, within the taxable year, of any indebtedness of the taxpayer or for which the taxpayer is liable evidenced by a security (as hereinafter in this paragraph defined) if —

(A) it is established to the satisfaction of the Commissioner, or

(B) it is certified to the Commissioner by any Federal agency authorized to make loans on behalf of the United States to such corporation or by any Federal agency authorized to exercise regulatory power over such corporation,

that at any time of such discharge, the taxpayer was in an unsound financial condition, and if the taxpayer makes and files at the time of filing the return, in such manner as the Commissioner, with the approval of the Secretary, by regulations prescribes, its consent of the regulations prescribed under section 113(b)(3) then in effect. In such case, the amount of any income of the taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with

respect to such indebtedness, shall not be included in gross income and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction. As used in this paragraph, the term "security" means any body, debenture, note, or certificate, or other evidence of indebtedness, issued by any corporation, in existence on June 1, 1939. This paragraph shall not apply to any discharge occurring before the date of the enactment of the Revenue Act of 1939, or in a taxable year beginning after December 31, 1942.

INTERNAL REVENUE CODE OF 1954

Section 61. (a) GENERAL DEFINITIONS. — Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: * * *

(12) Income from discharge of indebtedness.

Section 108. (a) EXCLUSION FROM GROSS INCOME.

(1) In GENERAL — Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if —

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent, or

(C) the indebtedness discharged is qualified business indebtedness.

(2) COORDINATION OF EXCLUSIONS —

(A) Title 11 Exclusion Takes Precedence — Subparagraphs (B) and (C) of paragraph (1) shall not apply to a discharge which occurs in a title 11 case.

(B) Insolvency Exclusion Takes Precedence Over Qualified Business Exclusion — Subparagraph (C) of paragraph (1) shall not apply to a discharge to the extent that the taxpayer is insolvent.

(3) INSOLVENCY EXCLUSION LIMITED TO AMOUNT OF INSOLVENCY — In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

Section 1017. (a) GENERAL RULE — If —

(1) an amount is excluded from gross income under subsection (a) of section 108 (relating to discharge of indebtedness), and

(2) under subsection (b)(2)(D), (b)(5), or (c)(1)(A) of section 108, any portion of such amount is to be applied to reduce basis,

then such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.

JUDICIARY AND JUDICIAL PROCEDURE, 28 U.S.C. (1994)

Section 1254. Courts of appeals; certiorari; certified questions

Cases in the courts of appeals may be revised by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree.

Supreme Court, U.S.
FILED
APR 26 1996
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(2)

No. 95-1420

In the Supreme Court of the United States

OCTOBER TERM, 1995

PHILIP MORRIS INCORPORATED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the income realized upon the repayment of loans denominated in foreign currencies that results solely from favorable changes in foreign currency exchange rates—and not from any forgiveness of debt—constitutes income from the discharge of indebtedness within the meaning of Section 108 of the Internal Revenue Code, 26 U.S.C. 108 (1982), as in effect for taxable years prior to 1987.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3a-14a) is reported at 71 F.3d 1040. The opinion of the Tax Court (Pet. App. 18a-38a) is reported at 104 T.C. 61.

JURISDICTION

The judgment of the court of appeals was entered on December 8, 1995. The petition for a writ of certiorari was filed on March 6, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant portions of Sections 108 and 1017 of the Internal Revenue Code, 26 U.S.C. 108, 1017 (1982), as in effect during the tax years involved in this case, are set forth at Appendix, *infra*, 1a-3a.

STATEMENT

1. Petitioner is a Virginia corporation. In 1980 and 1982, petitioner entered into several transactions in which it borrowed foreign currency from foreign lenders. Each of the loans was denominated in the foreign currency that was borrowed, not in U.S. dollars (Pet. App. 4a-7a, 19a-23a). In 1983 and 1984, petitioner repaid these borrowings in whole or in part, in each instance paying the full amount of foreign currency then due under the original terms of the loans. The lenders did not forgive any part of the debt or otherwise release taxpayer from its obligation to repay the full amount contractually owed (*id.* at 5a-7a, 20a-23a). Between the dates of the borrowings and the repayments, the foreign currencies in which the loans were denominated declined substantially in value against the dollar (*ibid.*). The difference between the dollar value of the foreign currencies on the borrowing dates and the cost in dollars of acquiring the foreign currencies used for repayment of the loans in 1983 was $20,908,319. For the loans repaid in 1984, this same difference was $897,352 (*ibid.*).

Petitioner acknowledges that the gains that it realized in 1983 and 1984 from the effect of the favorable exchange rate on its borrowing transactions represent income, and petitioner reported those amounts as income on its tax returns for those years. Petitioner took the position, however, that its gains

on the foreign loan transactions were income from the discharge of indebtedness that (i) may be excluded from gross income under Section 108(a)(1) of the Internal Revenue Code and (ii) is to be applied as a reduction of the basis of other property owned by petitioner under Section 1017 of the Code (Pet. App. 8a, 23a). The Commissioner disagreed and determined that deficiencies existed in petitioner's income taxes for 1983 and 1984. Petitioner sought review of the Commissioner's determination in the Tax Court (*ibid.*).

2. Petitioner contended that the issue presented in this case is controlled by *Kentucky & Indiana Terminal R.R.* v. *United States*, 330 F.2d 520 (1964), in which the Sixth Circuit held that repayment of a loan denominated in a foreign currency that had declined in value against the dollar resulted in income from the discharge of indebtedness that could be excluded from gross income under the predecessor of Section 108 (Pet. App. 31a-33a). The Tax Court agreed with the Commissioner, however, that, under this Court's decision in *United States* v. *Centennial Savings Bank FSB*, 499 U.S. 573 (1991), there was no income from the discharge of indebtedness within the meaning of Section 108 of the Code because none of the debt owed by petitioner was forgiven; instead, petitioner owed amounts of foreign currency that it repaid in full under the terms and conditions set forth in the loan agreements. The Tax Court held that income from the discharge of indebtedness arises under Section 108 only when a creditor accepts a performance that is less than the performance required by the original obligation (Pet. App. 35a) (emphasis added by court):

> We think the teaching of *Centennial Savings* is clear, namely that the discharge of an indebtedness may be the occasion for the realization of income but, unless there is a cancellation or forgiveness of a portion of the indebtedness not reflected in the terms of the indebtedness, such income is not realized "*by reason of the discharge* * * * of indebtedness of the taxpayer" * * * as required by section 108(a).

The court concluded that the interpretation of the term "income from the discharge of indebtedness" applied by the Sixth Circuit in *Kentucky & Indiana* was contrary to the interpretation of that term adopted by this Court in *Centennial Savings* and that the Sixth Circuit's decision had thus been effectively overruled (*id.* at 34a).

3. The court of appeals affirmed (Pet. App. 3a-14a). The court acknowledged that, under the Sixth Circuit's decision in *Kentucky & Indiana*, income of the type involved here would have been treated as income from the discharge of indebtedness (*id.* at 9a). The court of appeals agreed with the Commissioner, however, that this Court's decision in *Centennial Savings*, "while not expressly addressing foreign exchange transactions or the continued viability of *Kentucky & Indiana*, effectively undermined the latter decision" (*id.* at 11a). The court stated (*id.* at 13a):

> [W]e are not at liberty to entertain the taxpayer's position in light of the Supreme Court's clear holding in *Centennial Savings Bank* that Section 108(a) requires a forgiveness or release of an obligation of the underlying debt to constitute the

requisite discharge of indebtedness. 499 U.S. at 583.

ARGUMENT

The decision in this case correctly applies this Court's decision in *United States* v. *Centennial Savings Bank FSB*, 499 U.S. 573 (1991). Moreover, as petitioner acknowledges (Pet. 16-17 & n.3), Congress enacted significant revisions to the applicable statutory provisions in 1986. For all years after 1986, the question presented in this case is controlled by the specific language of these new provisions, which expressly require the same result reached by the court of appeals in this case. Further review of the decision in this case is therefore not warranted.

1. a. As in effect during the years involved in this case, Section 108 of the Internal Revenue Code provided that "[g]ross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if * * * the indebtedness discharged is qualified business indebtedness" (26 U.S.C. 108(a)(1) (1982)). The statutory definition of "qualified business indebtedness" included "indebtedness * * * incurred or assumed * * * by a corporation" (26 U.S.C. 108(d)(4)(A) (1982)). A corporate taxpayer that desired to exclude income from the discharge of qualified business indebtedness from its gross income had to elect to reduce the basis of its depreciable property by the amount of the exclusion. 26 U.S.C. 108(c)(1), 108(d)(4)(B), 1017 (1982). As this Court explained in *Centennial Savings*, "the effect of § 108 is no genuinely to exempt such income from taxation, but rather to defer the payment of the tax by reducing the

taxpayer's annual depreciation deductions or by increasing the size of taxable gains upon ultimate disposition of the reduced-basis property." 499 U.S. at 580.

The question involved in *Centennial Savings* was whether the penalties that a savings and loan association charged its depositors upon the premature withdrawal of funds from certificate of deposit accounts constituted income from the discharge of indebtedness. The savings and loan association in *Centennial Savings* contended that any spread between the amount of the debt that it assumed upon opening a certificate of deposit account and the lesser amount that it paid the depositor upon early closure of the account was income from the discharge of indebtedness within the meaning of Section 108. 499 U.S. at 576-577. The Court rejected that contention, holding that income from the discharge of indebtedness occurs only when the creditor agrees to cancel or forgive all or part of the debt that was originally contracted. The Court explained (*id.* at 580-581 & n.6) (emphasis in part by the Court):

> As used in § 108, the term "discharge . . . of indebtedness" conveys *forgiveness of*, or *release from*, an obligation to repay.
>
> * * * * *
>
> "Discharge" can be used to signify various means of extinguishing a legal duty. See generally, Black's Law Dictionary 463 (6th ed. 1990). Thus, a debtor might be said to "discharge" his debt by satisfying it. But § 108 uses "income by reason of the discharge . . . of indebtedness" to refer to the change in the debtor's financial con-

> dition when the debtor is no longer legally required to satisfy his debt either in part or in full. *"Discharge" in this sense can occur only if the creditor cancels or forgives a repayment obligation.*

Although the depositor's premature withdrawal in *Centennial Savings* enabled the taxpayer to satisfy its certificate of deposit liabilities for less than the amounts that otherwise would have been due—thereby generating income for the taxpayer—the Court held that such income was not derived from the discharge of indebtedness because the penalty was one of the original terms of the deposit agreement. The taxpayer's receipt of income from such penalties "was not the product of the release of any obligation assumed by [the taxpayer] at the outset of the bank-depositor relationship" (499 U.S. at 581).

Under this Court's decision in *Centennial Savings*, in determining whether a taxpayer has realized "income by reason of the discharge * * * of indebtedness" within the meaning of Section 108 of the Code, it is not enough to consider whether the taxpayer's cost of repaying a debt is lower than the value of the proceeds originally borrowed. Instead, if the amount repaid by the borrower is the full amount required to be paid under the terms of the original loan agreement—as in the present case—there is no income from the discharge of indebtedness under Section 108. 499 U.S. at 581-583.

b. The court of appeals correctly applied the rule of *Centennial Savings* in holding that petitioner did not realize income from the discharge of indebtedness upon its repayment of the foreign currency loans involved in this case. Petitioner was not relieved of

any repayment obligation that it assumed when it entered into the loan transactions (Pet. App. 11a-14a, 32a-37a). To the contrary, it is undisputed that (i) petitioner borrowed a specific amount of funds in foreign currency, (ii) petitioner was, at all times, obligated to repay the full amount of the foreign currency that it had borrowed, and (iii) petitioner in fact repaid *in full* the amount of currency that it was obligated to repay under the original terms of the loan agreements.

To be sure, petitioner realized taxable gains from its foreign currency dealings: between the dates of the borrowings and the dates of repayment, the foreign currencies declined in value in relation to the dollar, and petitioner was therefore able to purchase the foreign currencies needed to repay its loans at a cost in dollars that was substantially less than the dollar value of those currencies at the time that they were borrowed (Pet. App. 5a-7a, 19a-23a). But the gain that petitioner realized was attributable solely to favorable fluctuations in currency exchange rates, not to any discharge of indebtedness. Because no part of petitioner's indebtedness was released or forgiven by its lenders, there was no income from the discharge of indebtedness within the meaning of Section 108. See *United States* v. *Centennial Savings Bank FSB*, 499 U.S. at 581.

2. Petitioner contends (Pet. 8-9) that the decision in this case conflicts with the decision of the Sixth Circuit in *Kentucky & Indiana Terminal R.R.* v. *United States*, 330 F.2d 520 (1964). That contention, while true, ignores the effect of this Court's intervening decision in *Centennial Savings*.

In the *Kentucky & Indiana* case, the Sixth Circuit held that repayment of a loan denominated in a foreign

currency that had declined in value as against the dollar resulted in income from the discharge of indebtedness within the meaning of the statutory predecessor of Section 108. That 1964 decision of the Sixth Circuit, which conflicts with the decision in this case, cannot be reconciled with this Court's 1991 holding in *Centennial Savings* that a "discharge" of indebtedness for purposes of Section 108 "can occur *only* if the creditor cancels or forgives a repayment obligation" (499 U.S. at 581 n.6) (emphasis added). As the court of appeals emphasized in this case (Pet. App. 11a), that holding of this Court in *Centennial Savings* necessarily overruled the Sixth Circuit's contrary interpretation of Section 108 in *Kentucky & Indiana*.

Petitioner asserts (Pet. 12, 16), however, that *Centennial Savings* did not involve foreign currency transactions and therefore is not applicable in the specific context of this case. But there is nothing in *Centennial Savings* to suggest that the Court's interpretation of the statutory term "discharge * * * of indebtedness" was limited to the particular facts of that case. To the contrary, the Court's holding that a "discharge" of indebtedness for purposes of Section 108 can occur *only* if the creditor cancels or forgives a portion of the original debt (499 U.S. at 581 n.6) necessarily applies to every case in which the meaning of that statutory term is at issue. It therefore applies—and governs—in this case, as the court of appeals correctly held (Pet. App. 11a-12a).

3. No conflict of decisions has arisen in the application of *Centennial Savings* to foreign currency borrowings. Petitioner nonetheless makes the unsupported assertion that the decision in *Centennial Savings* has created "uncertainty" (Pet. 9),

"enormous confusion" (Pet. 12), and "significant confusion" (Pet. 16) for the treatment of foreign currency borrowings. It is evident, however, that no genuine confusion or uncertainty exists. Certainly, the courts below were not confused: the Tax Court stated that "the teaching of *Centennial Savings* is clear" (Pet. App. 35a), and the court of appeals found no difficulty in interpreting the "clear holding in *Centennial Savings Bank*" or in applying that holding to the facts of this case (*id.* at 13a).

Petitioner exhibits its own confusion by relying on the legislative history of Section 108 of the Code as support for its position in this case. According to petitioner, this legislative history shows that petitioner is an intended beneficiary of Section 108 because Congress desired to permit solvent corporations "to repurchase their bonds at a discount on the open market without incurring immediate tax liability" (Pet. 13). But the "discount" to which the legislative history refers is an acquisition by a corporation of its own debt instruments at a price less than their par or face value. See *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931); *Colonial Savings Ass'n* v. *Commissioner*, 854 F.2d 1001, 1004-1005 (7th Cir. 1988), cert. denied, 489 U.S. 1090 (1989); H.R. Rep. No. 855, 76th Cong., 1st Sess. 7 (1939). By contrast, petitioner did not settle its foreign debts for less than, or otherwise at a discount from, their par or face amounts. Instead, it repaid the full amount of the borrowings in the foreign currencies in which the borrowings were denominated. Petitioner did not realize income by reason of a forgiveness or discounting of its debts. Instead, petitioner realized income from the fluctuation in value of the foreign currencies in which it transacted its business.

4. The question presented in this case lacks recurring importance due to the extensive revision of the applicable statutory provisions made by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. For taxable years beginning after 1986, the income tax consequences of foreign currency transactions such as those involved in this case are governed by a new provision of the Code (Section 988) under which foreign currency gain is expressly treated as ordinary income.* See § 1261(a), 100 Stat. 2585 (adding Section 988 of the Code). Moreover, Section 822(a) of the 1986 Act, 100 Stat. 2373, repealed any application of the discharge of indebtedness rules of Section 108 to qualified business indebtedness. As the result, Section 108 of the Code now applies only to situations in which the taxpayer is insolvent or in bankruptcy at the time of the discharge of indebtedness. The question presented in this case thus lacks any recurring importance to the administration of the tax laws.

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* Petitioner acknowledges (Pet. 16-17) that Section 988 was designed to reverse the result of the decision of the Sixth Circuit in *Kentucky & Indiana*.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APRIL 1996

APPENDIX

1. Section 108 of Title 26 of the United States Code (1982) provided, in relevant part:

(a) **Exclusion from gross income**

(1) **In general**

Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent, or

(C) the indebtedness discharged is qualified business indebtedness.

* * * * *

(c) **Tax treatment of discharge of qualified business indebtedness**

In the case of a discharge of qualified business indebtedness—

(1) **Basis reduction**

(A) **In general**

The amount excluded from gross income under paragraph (C) of subsection (a)(1) shall be applied to reduce the basis of the depreciable property of the taxpayer.

(B) **Cross reference**

For provisions for making the reduction described in subparagraph (A), see section 1017.

* * * * *

(d) **Meaning of terms; special rules relating to subsections (a), (b), and (c)**

* * * * *

(4) **Qualified business indebtedness**

Indebtedness of the taxpayer shall be treated as qualified business indebtedness if (and only if)—

(A) the indebtedness was incurred or assumed—

(i) by a corporation, or

(ii) by an individual in connection with property used in his trade or business, and

(B) such taxpayer makes an election under this paragraph with respect to such indebtedness.

* * * * *

2. Section 1017 of Title 26 of the United States Code (1982) provided, in relevant part.

(a) **General Rule**
If—

(1) an amount is excluded from gross income under subsection (a) of section 108 (relating to discharge of indebtedness), and

(2) under subsection (b)(2)(D), (b)(5), or (c)(1)(A) of section 108, any portion of such amount is to be applied to reduce basis,

then such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.

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No. 95-1420

In The

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October Term, 1995

PHILIP MORRIS INCORPORATED,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY BRIEF FOR PETITIONER

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May 7, 1996

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RULE 29.6 STATEMENT

There has been no change in the information provided in the Rule 29.6 Statement in the Petition.

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REPLY BRIEF FOR PETITIONER

Respondent's adroit footwork in her Brief in Opposition cannot conceal the glaring omissions in her analysis.

The reason petitioner realized "gross income" on the repayment of its foreign currency borrowings is because, for U.S. tax purposes, those borrowings were required to be

treated as if they were U.S. dollar borrowings.[1/] Once that rule is acknowledged -- something respondent has not been willing to do -- it becomes clear that the Sixth Circuit reached the correct result in Kentucky & Indiana Terminal R.R. v. United States, 330 F.2d 520 (6th Cir. 1964).

It is true, as respondent states, that a change in exchange rates enabled petitioner to repay its indebtedness with currency having a lower dollar value than the value of the currency it borrowed. But that fact only explains the economic result of repayment. Petitioner derived "gross income" on repayment under the rule of United States v. Kirby Lumber Co., 284 U.S. 1 (1931) -- the repayment of a debt for less than its face amount gives rise to gross income.

Recognizing the force of the foregoing, respondent asserts that "if the amount repaid by the borrower is the full amount required to be paid under the terms of the original loan agreement -- as in the present case -- there is no income from the discharge of indebtedness under Section 108. [citation omitted]." (Resp. Br. 7.) Respondent then concludes that "petitioner did not settle its foreign debts for less than, or otherwise at a discount from, their par or face amounts." (Resp. Br. 10.)

Contrary to respondent's assertion, petitioner's foreign currency borrowings were U.S. dollar borrowings for U.S.

[1/] See Gillin v. United States, 423 F.2d 309, 313 (Ct. Cl. 1970); National-Standard Co. v. Commissioner, 80 T.C. 551, 563-64 (1983), aff'd 749 F.2d 369 (6th Cir. 1984); America-Southeast Asia Co. v. Commissioner, 26 T.C. 198, 200 (1956).

tax purposes, not "foreign debts." More importantly, petitioner did not repay its foreign currency borrowings "in full" or at their "face amounts" for U.S. tax purposes simply because it returned the exact number of foreign currency units it had borrowed. (Resp. Br. 7-8, 10.) For U.S. tax purposes, when foreign currency is borrowed, the "full amount required to be paid" is the U.S. dollar value of the foreign currency when borrowed. The "amount repaid" is the U.S. dollar value of the foreign currency when repayment is made. Where, as here, the latter is less than the former, ordinary income is realized because the creditor accepts in repayment currency with a lesser dollar value than the dollar value of the currency it loaned.[2/]

Respondent's conclusion that petitioner paid its debts in full is not only erroneous, but also diametrically opposed to respondent's position as upheld in America-Southeast Asia Co. v. Commissioner, 26 T.C. 198 (1956). In that case, the Tax Court ruled that the gain realized as a result of currency fluctuations at the time of repayment of a foreign currency borrowing incurred to purchase goods was ordinary income, not capital gain, because it was "a gain arising directly out of petitioner's trade or business from the settlement of a debt incurred therein for less than its face amount. . . . See United

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[2/] Indeed, respondent's simplistic "units for units" analysis leads to the logical conclusion that petitioner realized no income at all on repayment of its foreign currency borrowings. B.F. Goodrich Co. v. Commissioner, 1 T.C. 1098 (1943), acq. 1943-1 C.B. 10 (withdrawn), nonacq. 1974-2 C.B. 5.

States v. Kirby Lumber Co., 284 U.S. 1 (1931) [other citations omitted]." Id. at 200-01 (emphasis added).

Respondent does not indicate precisely why this Court's decision in United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991), has caused her to change her position on this point and conclude that petitioner settled its debts at their face amounts.

* * *

The Second Circuit below felt it had no choice but to apply the holding of Centennial on a literal basis. The court ruled that in the absence of a negotiated release petitioner's indebtedness was not "discharged" within the meaning of section 108. Yet, the court evidenced strong doubts about the propriety of the result it reached. It also recognized that in dollar terms -- the only terms relevant for U.S. tax purposes -- petitioner did indeed settle its debts for less than their face amount, precisely as contemplated by the legislative history of section 108.[3/] (Pet. App. 12a-13a.)

The issue presented by the petition for certiorari is whether this Court can properly ignore the square conflict between the Second and Sixth Circuits caused by its decision in Centennial. Surely the existence of such a conflict, attributable entirely to this Court's intervening decision that admittedly did not consider the application of section 108 in

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[3/] While there was in fact no negotiated release or forgiveness here, that is also true in the case of open market repurchases of bonds, as in United States v. Kirby Lumber Co., 284 U.S. 1 (1931), the very case that led to the enactment of section 108.

the context of foreign currency borrowings, requires an exercise of this Court's supervisory powers to resolve the conflict regardless of subsequent statutory amendments.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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BRIEF OF UNISYS CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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BRIEF OF UNISYS CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Unisys Corporation files this brief amicus curiae in support of the petition for writ of certiorari filed by Philip Morris Incorporated. Unisys is a multinational corporation presently engaged in a controversy with the Internal Revenue Service regarding the proper tax treatment of income realized

on the repayment of certain foreign currency borrowings entered into in the ordinary course of its business. One of the issues involved in that controversy is the issue presented in the instant case.[1/]

REASONS FOR GRANTING THE WRIT

Unisys strongly urges this Court to resolve the conflict between the Second Circuit decision below and the Sixth Circuit decision in Kentucky & Indiana Terminal R.R. v. United States, 330 F.2d 520 (6th Cir. 1964). Taxpayers had consistently relied on Kentucky & Indiana in determining the tax consequences of income realized on the repayment of foreign currency borrowings. At no time prior to the decision of the Tax Court in the instant case was there any indication that Kentucky & Indiana would not govern the issue here presented.

Nothing in United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991), indicates the slightest focus by this Court on the unique tax treatment accorded transactions involving foreign currency. A decision that considered only the taxability of penalty income realized by a bank on the early withdrawal of a domestic certificate of deposit should not, without more, be controlling in the far different and considerably more complex realm of foreign currency transactions.

In its petition for certiorari, Philip Morris points out the illogic of allowing Centennial Savings Bank to control the outcome of the instant case. A U.S. taxpayer is required to

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[1/] Both petitioner and respondent have consented to the filing of this brief in letters lodged with the Clerk of this Court.

treat a borrowing of foreign currency as if it were a borrowing of U.S. dollars. That is why income may be realized on repayment even though the exact amount of foreign currency borrowed is repaid. To deny the taxpayer the benefit of tax deferral in such a case simply because, for business reasons, it in fact borrowed foreign currency rather than U.S. dollars directly is not only arbitrary but also contrary to the purpose for which I.R.C. section 108(a) was enacted.

Surely Congress did not intend that the IRS could have it both ways -- requiring the taxpayer to use a dollar-based calculation to determine whether any income was realized on repayment of the debt, but a foreign currency-based calculation to determine whether any such income was eligible for tax deferral. If the IRS is correct and the number of currency units repaid is to determine eligibility for tax deferral, then the number of currency units repaid should also determine whether there is income in the first instance. If 100 million Swiss francs are borrowed and 100 million Swiss francs are repaid, it would be quite logical to conclude that there was no income at all as a result of the repayment. See B.F. Goodrich Co. v. Commissioner, 1 T.C. 1098 (1943), a case reaching that conclusion but not followed in later decisions.

As the petition for certiorari makes clear, Congress sought through section 108(a) to encourage the repayment of debt when a debtor had the opportunity to pay off its obligations at less than face value. Since repayment would give rise to taxable income in those circumstances under the rule of United States v. Kirby Lumber Co., 284 U.S. 1 (1931), Congress undertook to provide relief in the form of

tax deferral. Otherwise, the transaction would trigger a current tax that would require an additional cash outlay. Taxpayers might then find themselves unwilling or unable to take advantage of the opportunity to repay their debts at a discount even though, from an economic point of view, it would be desirable to do so.

The petition for certiorari also points out the inconsistency between this Court's holdings in Centennial Savings Bank and Kirby Lumber Co. If Centennial Savings Bank is read literally, it would appear that even a debtor similar to the debtor involved in Kirby Lumber Co. would not qualify for the benefit of section 108(a). But this Court took pains in Centennial Savings Bank to show that Kirby Lumber Co. was consistent with its interpretation of the statute. That being the case, a literal application of Centennial Savings Bank -- which the Second Circuit adopted below -- cannot be required in those situations where, as here, negotiating a creditor's release makes no sense.

Unisys believes that if a Kirby Lumber type of situation is intended to be within the scope of section 108(a), as it clearly is, the courts below have misapplied this Court's holding in Centennial Savings Bank. It is clear from the opinion of the Second Circuit that, but for a literal application of Centennial Savings Bank, section 108(a) would have been available to petitioner here, as a borrower of foreign currency that took advantage of market conditions and repaid its debt when the dollar value of the currency had declined. Since a borrower of foreign currency must account for the transaction in dollar terms, it is completely inappropriate to ignore the dollar aspects of the transaction in

determining whether the borrower is entitled to tax deferral with respect to the income realized on repayment.

At a minimum, Centennial Savings Bank has severely muddied the waters in this area. A clarification of the scope of section 108(a) has therefore become essential to permit a proper resolution of pending tax audits without continuing controversy.

CONCLUSION

For all of the foregoing reasons, Unisys respectfully urges this Court to grant the petition for writ of certiorari.

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April 5, 1996.